

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

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OFFICE OF THE SECRETARY

In the Matter of

Price Cap Performance for
Local Exchange Carriers

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CC Docket No. 94-1

REPLY COMMENTS

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SUMMARY

In its opening Comments in this proceeding, U S WEST reiterated that price cap regulation was no longer an untested theory and that by any measure price cap regulation was a success. This was evidenced by the fact that under price cap regulation:

1) access prices have declined; 2) service quality has been maintained; 3) significant investment in telecommunications infrastructure has occurred; 4) telephone subscribership has increased; and 5) local exchange carriers ("LEC") have increased efficiency. U S WEST urged the Commission to concentrate on three simple goals in this price cap review proceeding:

- 1) remove the last remnants of rate of return regulation from price cap regulation;
- 2) modify the price cap plan to accommodate competition; and
- 3) streamline the rules for introducing new services.

Achievement of these goals would represent a major step toward the use of true incentive regulation.

Not surprisingly, most non-LEC commenters claimed that competition was all but non-existent in interstate access markets and recommended a plethora of "rate-of-return like" adjustments which would remove virtually all incentives from the LEC price cap plan. For all intents and purposes, their recommendations represent a total repudiation of incentive regulation. Their support for price cap regulation is in name only. Rather than a point-by-point rebuttal of opponents' proposals, U S WEST restricts its reply comments to those areas where parties

distorted the facts, misconstrued the law, or where clarification or rebuttal was necessary to set the record straight.

With regard to competition, there are significant differences among the commenters, with IXC's and CAP's basically arguing that the Commission need not adopt a transition mechanism since competition is nonexistent. U S WEST believes that competition already has emerged in interstate markets and will only grow further. LEC's will be harmed unnecessarily if the Commission does not modify the price cap plan to accommodate competition. Conversely, if competition does not flourish, no party would be harmed by Commission adoption of a transition mechanism which is never triggered. Thus, disagreement over the current level of LEC competition should not deter the Commission from adopting a transition mechanism in this proceeding.

Numerous parties argue that LEC price cap indices should be reduced to reflect the decline in interest rates and the cost of capital since the introduction of price cap regulation. These parties forget that the cost of capital changes has no role in a price cap plan. Under price cap regulation, prices are capped by a set formula and LEC's are incented to provide service in the most efficient manner, regardless of what happens to the various cost components. Any cost of capital adjustments in effect would constitute a re-prescription of the cost of capital for price cap LEC's. Neither the Commission's price cap rules nor Part 65 Rules allow for a cost of capital prescription to reset LEC price cap rates. As such, the Commission should decline to address the issue of cost of capital adjustments in this proceeding. The

Commission has already found that price cap regulation is a more efficient form of regulation.

In their quest to obtain even lower access rates, several parties argue that the productivity factor in the LEC price cap formula should be increased significantly. These parties present no reliable evidence of productivity gains but base their productivity arguments on claims of excessive LEC earnings since the adoption of price cap regulation. In this Reply, U S WEST demonstrates that neither opponents' productivity conclusions nor their claims of excessive LEC earnings have any merit. Adjusting the productivity factor to reflect gains since the introduction of price caps is nothing more than an attempt to recapture LECs' share of price cap productivity gains. This would diminish LEC incentives going forward and send the wrong signals to customers, competitors, and financial markets.

The last major item that U S WEST addresses in its Reply is pricing flexibility. In discussing pricing flexibility and pricing standards for new and existing services, it seems that everyone, except for LECs, has "a better idea" as to how LECs should be further restricted. These parties claim to favor competition and assert that adoption of their proposals will prevent discrimination and cross-subsidization. U S WEST disagrees. The only thing that adoption of commenters' proposals will do is to further their private interests and place LECs in a regulatory straitjacket. If the Commission is serious about its goal of increasing access competition, it should identify LEC services that are subject to competition and remove them from price cap regulation.

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REPLY COMMENTS

U S WEST Communications, Inc. ("U S WEST"), through counsel, and pursuant to the Federal Communications Commission's ("Commission") Order,¹ hereby files its Reply Comments in the Commission's Price Cap Review proceeding.²

I. INTRODUCTION

A. Overview of U S WEST's Position

In its opening Comments in this proceeding, U S WEST reiterated that price cap regulation was no longer an untested theory and that by any measure price cap regulation was a success.³ This was evidenced by the fact that under price cap regulation:

1) access prices have declined; 2) service quality has been maintained; 3) significant investment in telecommunications infrastructure has occurred; 4) telephone subscribership has increased; and 5) local exchange carriers ("LEC") have increased

¹In the Matter of Price Cap Performance Review for Local Exchange Carriers, Motion for Extension of Time and Motion to Compel Production of Data, CC Docket No. 94-1, Order, DA 94-601, rel. June 8, 1994, ¶ 5 ("Order").

²In the Matter of Price Cap Performance Review for Local Exchange Carriers, Notice of Proposed Rulemaking, 9 FCC Rcd. 1687, 1707 ¶ 107 (1994) ("Notice of Proposed Rulemaking").

³U S WEST at 2-4.

efficiency.⁴ U S WEST urged the Commission to concentrate on three simple goals in this price cap review proceeding:

- 1) remove the last remnants of rate of return regulation from price cap regulation;
- 2) modify the price cap plan to accommodate competition; and
- 3) streamline the rules for introducing new services.⁵

These goals are in concert with the Commission's original price cap goals and their incorporation into the LEC price cap plan would represent a major step toward the use of true incentive regulation.

One of the last remnants of rate of return regulation which must be eliminated is the sharing and low-end adjustment mechanism. These adjustments are essentially rate of return overlays which dull and distort LEC incentives under price cap regulation. There is no justification for continued use of the sharing and low-end adjustment mechanism when the LEC price cap plan already contains safeguards against unreasonable LEC pricing behavior, including a productivity offset, a consumer productivity dividend, and numerous indices and sub-indices.

U S WEST believes the best way to modify the current price cap plan to accommodate competition is to remove competitive services from price cap regulation as competition evolves using the United States Telephone Association's ("USTA") Access Reform

⁴Id. at iii.

⁵Id.

Proposal.⁶ Once competition has reached a certain level in a market area, pervasive price and service regulation is counter-productive. It sends the wrong signals to competitors, customers, and financial markets and unfairly penalizes LECs.

Lastly, current Commission Rules unnecessarily impede the introduction of new LEC services. These Rules must be streamlined if the Commission is to achieve its price cap objectives. The need is even more urgent in those areas of the business where competition is becoming the norm. At a minimum, the Commission must: 1) eliminate the requirement to obtain Part 69 waivers; 2) reduce notice periods; 3) reduce the need for detailed cost showings; 4) streamline the Section 214 process; 5) reduce the need for Part 61 waivers; and 6) allow LECs greater freedom to modify new service prices.

In addition to the above items, U S WEST addressed possible modifications to the interstate price cap formula -- 1) opposing one-time or ongoing adjustments to reflect changes in interest rates or the cost of capital; 2) supporting the elimination of exogenous cost adjustments; 3) finding continued use of a 3.3 percent total productivity offset to be acceptable with the elimination of sharing; and 4) finding that the Balanced 50/50 Formula to cap common line charges was an unnecessary distortion.

⁶In the Matter of Reform of the Interstate Access Charge Rules, RM-8356, USTA's Petition for Rulemaking filed Sep. 17, 1993 ("USTA Proposal").

B. Positions of Other Parties

Thirty-nine parties filed comments in the opening round of this proceeding.⁷ These parties consisted of price cap LECs, interexchange carriers ("IXC"), competitive access providers ("CAP"), consumer advocates, large users, small LECs, and cable companies. It should come as no surprise that there was substantial disagreement among the parties. However, there were a few issues that parties agreed upon -- at least in principle. The parties generally agreed that price cap regulation had not harmed

⁷Ad Hoc Telecommunications Users Committee ("Ad Hoc"); Aeronautical Radio, Inc. ("ARINC"); American Library Association ("ALA"); Ameritech; Association for Local Telecommunications Services ("ALTS"); AT&T Corp. ("AT&T"); Bell Atlantic Telephone Companies ("Bell Atlantic"); BellSouth Telecommunications, Inc. ("BellSouth"); California Cable Television Association ("CCTA"); Cincinnati Bell Telephone Company; Citizens for a Sound Economy Foundation ("CSE"); Competitive Telecommunications Association ("CompTel"); Computer & Communications Industry Association ("CCIA"); Council of Chief State School Officers, and The National Association of Secondary School Principals ("School Commissioners"); Eagle Telephonics, et al.; General Services Administration ("GSA"); GTE Service Corporation and its affiliated domestic telephone operating companies ("GTE"); Intermedia Communications of Florida, Inc.; International Communications Association ("ICA"); The Lincoln Telephone and Telegraph Company ("Lincoln"); MCI Telecommunications Corporation ("MCI"); MFS Communications Company, Inc. ("MFS"); National Rural Telecom Association ("NRTA"); National Telephone Cooperative Association ("NTCA"); NYNEX Telephone Companies ("NYNEX"); Office of the Consumers' Counsel, State of Ohio ("OCCO"); The Organization for the Protection and Advancement of Small Telephone Companies ("OPASTCO"); Pacific Bell and Nevada Bell ("Pacific"); Pennsylvania Office of Consumer Advocate ("PaOCA"); Rochester Telephone Corporation ("Rochester"); Southern New England Telephone Company ("SNET"); Southwestern Bell Telephone Company ("SWBT"); Sprint Corporation ("Sprint"); Teleport Communications Group Inc. ("TCG"); Tele-Communications Association ("TCA"); Time Warner Communications ("Time Warner"); USTA; WilTel, Inc. ("WilTel"); and U S WEST.

universal service and that universal service issues should be addressed in a separate proceeding.⁸

Another point on which the parties "theoretically" agreed was that price cap regulation represented an improvement over rate of return regulation. A review of the comments indicates that agreement on this point was illusory at best. For example, several parties claim that LEC price cap indices ("PCI") and rates should be reduced to reflect:

- declines in the cost of capital and interest rates;
- increases in LEC earnings above the previously authorized rate of return; and
- LEC productivity gains in excess of 3.3 percent.

In suggesting such modifications, these parties cannot in all honesty claim that they favor price cap regulation over rate of return regulation when LEC PCIs have fallen and LECs are priced below their caps. These parties may use the term "price cap regulation" to describe their proposals, but that is the same as describing "a wolf in sheep's clothing."⁹ Clearly, adoption of

⁸It should be noted that a few parties suggested that universal service should be expanded to include wiring schools and libraries. See ALA at 2; CCIA at 12; School Commenters at 1-2. But, as a whole, commenting parties overwhelmingly favored deferring universal service issues to a separate proceeding.

⁹See, e.g., MCI's proposals at 27 (a one-time reduction in LEC PCIs of 7.5 percent to reflect LEC productivity gains in excess of 3.3 percent for the 1991-1993 period and an adjustment in LEC PCIs to reflect lower cost of capital), 18 (an increase in the LEC productivity factor to 5.9 percent), 47-48 (a downward exogenous cost adjustment for equal access network reconfiguration and sales/swaps of exchanges), 41-44 (the elimination of exogenous cost treatment of any items such as Other Post Employ-
(continued...)

any such proposals will represent a step backward toward rate of return regulation, not an improvement in price cap regulation.

A point on which the parties truly agreed in principle was that LEC regulation should be streamlined once competition was shown to exist. Not surprisingly, the various parties' discussions of competition sounded like the "Tower of Babel." Parties disagree on, among other things: 1) the relevant markets to be examined; 2) the means of measuring competition; 3) threshold levels of competition; 4) the power of large access customers; 5) the existence of barriers to entry; and 6) the current level of competition.

Other than the above few items, there was little, if any, agreement among the different classes of commenters. While there were differences in views within each class of participants, for the most part these differences were minimal compared to the differences between classes.¹⁰ As a whole, price cap LECs favored a movement towards greater incentive regulation with more flexibility in introducing new services and greater freedom to respond to competition. Price cap LECs supported the elimination of sharing and low-end adjustments,¹¹ the same or a reduced

⁹(...continued)
ment Benefits ("OPEB") which might result in upward adjustments to LEC PCIs), 29-30 (a reduction in sharing thresholds).

¹⁰An exception to this observation was U S WEST's proposal that exogenous cost treatment be eliminated on a ongoing basis. U S WEST at 46-47.

¹¹Ameritech at 14; Bell Atlantic at 7-12; BellSouth at 9, 47; NYNEX at 30-31; Pacific at 43-49; SWBT at 43-47; Sprint at 5, 13-15; GTE at 67-69; Lincoln at 3, 11-12; Rochester at 12-13, 20; U S WEST at 8-12.

productivity offset,¹² a reduction in the number of baskets and bands,¹³ greater pricing flexibility,¹⁴ elimination of the 50/50 formula for capping the common line basket¹⁵ and opposed one-time adjustments for cost of capital and interest rate changes.¹⁶ IXC's and parties representing large users favored any price cap adjustments which would ensure an immediate reduction in LEC's rates under price cap regulation, including higher productivity offsets,¹⁷ one-time adjustments for cost of capital and interest rate decreases,¹⁸ elimination of the low-end adjustment,¹⁹ reductions in sharing thresholds,²⁰ limitations on exogenous cost treatment,²¹ and offsets and subsidies associated

¹²Ameritech at 12-13; Bell Atlantic at 15-17; BellSouth at 46-47; GTE at 73-75; Lincoln at 7-10; NYNEX at 41; Pacific at 28; Rochester at 19; SWBT at 33; SNET at 13-14; U S WEST at 34-35.

¹³Ameritech at 8-11; BellSouth at 20-32, 92-95; GTE at 62-64; Lincoln at 13; NYNEX at 23-27; Pacific at 27; Rochester at 18; SWBT at 81-87; U S WEST at 30-33, 88-89.

¹⁴Ameritech at 11; Bell Atlantic at 27; BellSouth at 92-95; GTE at 40; Lincoln at 13; NYNEX at 26-27; Pacific at 26; SWBT at 87-89; U S WEST at 30-33.

¹⁵Bell Atlantic at 17-18; BellSouth at 53-54; GTE at 72-77; Pacific at 51; U S WEST at 44-47.

¹⁶Bell Atlantic at 12; BellSouth at 38; NYNEX at 32-35; Pacific at 28; SWBT at 40-41; Lincoln at 10-11; Rochester at 19; CSE at 4; U S WEST at 16-17.

¹⁷AT&T at 23-24; MCI at 18; Ad Hoc at 21; WilTel at 25; ARINC at 2; OCCO at 7; GSA at 8-10; ICA at 11-13; PaOCA at 6-7; Sprint at 11-12.

¹⁸CCTA at 5; OCCO at 7; Ad Hoc at 25; AT&T at 30-33; GSA at 4, 6; MCI at 27; WilTel at 25.

¹⁹AT&T at 34-38; ICA at 14; MCI at 32; Sprint at 13.

²⁰Ad Hoc at 25; AT&T at 33; GSA at 7-8; MCI at 29.

²¹OCCO at 10; Ad Hoc at 25-26; ICA at 16; MCI at 42; WilTel at 27.

with the sale/swap of local exchanges.²² CAPs, on the other hand, focused on ensuring that price cap LECs have as little pricing flexibility as possible and the highest possible prices.²³ CAPs advocated competitive tests and thresholds which all but guaranteed that LECs would not gain any pricing flexibility in the foreseeable future.²⁴ Consumer advocates, generally uncomfortable with any form of incentive regulation, argued that the Commission needs to take steps to protect end users from excessive prices.²⁵

To a large extent, the lines are drawn between the parties in this proceeding. Nothing would be gained by repeating earlier arguments and rebutting opposing parties' arguments ad infinitum. None of the arguments of other parties in the opening round of comments has caused U S WEST to modify any of its positions in this proceeding. The same is probably true for most other participants. In the comments which follow, U S WEST responds to those areas of the opening comments where parties distort the facts, misconstrue the law, or where clarification or rebuttal is critical to correcting the record.

²²AT&T at 49-52; MCI at 59-62.

²³MFS at 12-15; TCG at 25.

²⁴ALTS at Exhibit A, Guidelines for Designing Federal Regulatory Policy to Promote Competitive Local Telecommunications Services, by Jerry B. Dewall and John G. Williams, May 1994; MFS at 46-50; TCG at 17-18; Time Warner at 12-15.

²⁵OCCO at 3; PaOCA at 1-2.

**II. DISAGREEMENT OVER THE CURRENT LEVEL OF LEC COMPETITION
SHOULD NOT DETER THE COMMISSION FROM MODIFYING THE
PRICE CAP PLAN TO ACCOMMODATE COMPETITION**

In the opening comments, U S WEST and other LECs presented extensive evidence of the extent and growth of competitive alternatives to LEC interstate access services.²⁶ In particular, LECs noted that a large amount of their business is highly vulnerable to competition because of the concentrated nature of LEC traffic.²⁷ For example, U S WEST noted that 0.1 percent of the land area in the State of Washington generated 30 percent of

²⁶Ameritech at 29-31; Bell Atlantic at 4-5; BellSouth at Attachment 1 at 3-6; GTE at 28; NYNEX at Attachment B; Pacific at 72-96; SWBT at Appendix Comp, Demonstration of Competition in SWBT's Access Markets; U S WEST at 69-77.

²⁷Ameritech at 30; Bell Atlantic at Affidavit of Richard E. Beville in Support of Comments of Bell Atlantic at 2; BellSouth at Attachment 2; GTE at Attachment C; NYNEX at 13-18; Pacific at 75; SWBT at Appendix Comp at 3-4; U S WEST at 73-74, Attachment 8.

its business calling revenues.²⁸ Similar data was provided by Bell Atlantic, NYNEX, and Pacific.²⁹

IXCs and CAPs took just the opposite approach. They lumped all LEC revenues together, regardless of jurisdiction, geography, or type of service, and claimed that LECs' very high share of these revenues was evidence of the continuing lack of competition.³⁰ IXC's and CAPs went on to assert that an incredible number of threshold conditions must first be met before the Commission could even consider modifying the LEC price cap plan to accommodate competition. Among others, these threshold criteria included:

²⁸When U S WEST filed its Comments on May 9, 1994, two CAPs were authorized to provide local exchange service. See In the Matter of the Petition of Digital Direct of Seattle, Inc., for an Order Granting Amendment to Registration Application and Authorizing the Provision of Inter- and Intra-exchange Switched Telecommunications Services, Washington Utilities and Transportation Commission Docket No. UT-940529, Order, rel. May 25, 1994; and see Network World, Inc., May 30, 1994, at 2.

Since then, two additional CAPs -- Tel-West Central Services, Inc., and MFS Intelenet of Washington, Inc. -- have applied for certification as local exchange carriers. See In the Matter of the Application of MFS Intelenet of Washington, Inc., for an Order Authorizing the Registration of Applicant as a Telecommunications Company, Washington Utilities and Transportation Commission Docket UT-940670, Authorizing Registration, rel. June 22, 1994; In the Matter of the Petition of Tel-West Central Services, Inc. for an Order Granting Amendment to Competitive Telecommunications Company Classification, Washington Utilities and Transportation Commission Docket No. UT-940691, Notice of Formal Investigation and Fact-Finding, rel. June 13, 1994.

²⁹See USTA at Attachment 2 at Appendix B at B-2 through B-3. (Bell Atlantic derived 71 percent of its special access revenue from 15 percent of its wire centers; Pacific generated 49 percent of its business calling revenues from less than 1.0 percent of its land area (Figure B-2C); and 30 percent of NYNEX's business revenues are derived from 0.3 percent of its land area.)

³⁰AT&T at 9; MFS at 39; TCG at 23; Ad Hoc at Attachment A at 101-02.

- elimination of all state regulatory constraints on local exchange competition;³¹
- unbundling of LEC basic network functions;³²
- removal of any restrictions on the use of rights-of-way and conduit;³³
- the establishment of number portability;³⁴
- cost-based nondiscriminatory rates for all unbundled functions;³⁵
- elimination of all barriers to entry, including collocation restrictions, most LEC termination liabilities, most LEC volume and term discounts, high LEC rearrangement charges, etc.;³⁶
- when 30 percent of the subscribers are using alternative providers of local exchange service;³⁷
- when alternative local service is available to at least 75 percent of the subscribers in a local exchange;³⁸ and
- when service is available from two or more alternative providers who are not dependent on LEC facilities to provide service.³⁹

The list goes on. LECs would, in all likelihood, cease to be viable economic enterprises if the Commission adopted even a

³¹AT&T at 17; MFS at 46-49.

³²AT&T at 17; MCI at 68; MFS at 46-49.

³³AT&T at 17; MFS at 47.

³⁴AT&T at 18; MCI at 69; MFS at 51.

³⁵AT&T at 17; MCI at 75-76.

³⁶AT&T at 17.

³⁷Id. at 18.

³⁸Id. at 18-19 n.24.

³⁹Id.

portion of the criteria proposed by IXC's and CAP's before lifting regulatory restraints on LEC services subject to competition. In particular, these proposals are all based on the unsupported notion that the interstate access market is inseparable from the local exchange market. Clearly, these markets are separable, both jurisdictionally and from a marketing perspective. For example, interstate access markets are highly concentrated -- with 86 percent of LEC access services delivered to just three customers -- AT&T, MCI, and Sprint.⁴⁰ In contrast, local exchange markets are very diffuse -- U S WEST serves approximately 9.8 million residence customers and approximately 3.9 million business customers.⁴¹ The only purpose of lumping together these widely diverse markets is to develop the misleading refrain -- that LECs continue to enjoy a 99 percent market share. But, as Professor G. Harris of the University of California at Berkeley points out:

Historical market share, especially as defined and measured by LEC competitors, is a highly biased measure of competition in access services, because it does not account for the "Schumpeterian" forces of rapid technological change; does not account for state regulation of LECs and their franchise obligations; fails to include all sources of supply; and exaggerates the implications of LECs' "ubiquitous" networks.⁴²

⁴⁰See Trends in Telephone Service, Industry Analysis Division, Federal Communications Commission, May 1994, at 41.

⁴¹See U S WEST 1993 Annual Report Fact Book at 14.

⁴²Reply Comments of USTA filed simultaneously herewith ("USTA Reply") at Attachment, Reply Report on LEC Price Cap Reforms: United States Telephone Association, by Professor Robert G. Harris, University of California, Berkeley, and Law & Economics Consulting Group, Inc., June 24, 1994 ("Harris Report"), at 11 (footnote omitted).

MFS and TCG argue that it is necessary to consider the local exchange and interstate access markets jointly because LECs use joint facilities to provide these services. They claim that LECs can cross-subsidize competitive services with revenues from less competitive services.⁴³ These arguments ignore both safeguards which are inherent in the price cap system and the current direction of subsidy flows.

First, the basket and band structure inherent in the price cap system minimizes the possibility that price cap LECs could raise the price of a less competitive service in order to recover revenues lost from lowering prices on competitive services. Moreover, if the Commission adopts U S WEST's proposal to eliminate sharing and remove competitive services from price caps entirely, LECs would have virtually no opportunity to increase the price of less competitive services in order to lower the price of a competitive service.

Secondly, current interstate access rules require LECs to price their interstate access services to include support flows to less competitive services -- not the other way around. Examples of such subsidies include the current geographic averaging of rates,⁴⁴ the recovery of non-traffic sensitive costs

⁴³MFS at 19, 39; TCG at 23. MFS and TCG conveniently ignore the fact that there is no legal basis to support their "joint facilities" argument. See Louisiana Public Service Com'n v. FCC, 106 S. Ct. 1890, 1902 (1986); and see 47 USC §§ 152(b), 221(b).

⁴⁴While the Commission has granted U S WEST the ability to deaverage its prices into three density zones, U S WEST has not yet proposed such deaveraging. And, once U S WEST does deaverage its special and switched access rates, the pricing rules for the zones serve to substantially limit the extent of such deaveraging.

through traffic sensitive carrier common line rates, the inter-connection charge, and long term support payments to the National Exchange Carrier Association, Inc. Thus, the Commission's attention should be directed at reforming its Rules to remove subsidies that flow from competitive services to less competitive services.

The Commission should reject CAP and IXC proposals to establish measures associated with the level of competition in local exchange markets (i.e., as opposed to interstate markets) as preconditions for allowing LECs additional pricing flexibility for interstate access services.⁴⁵ These proposals are merely self-serving attempts by these competitors to handicap LECs.⁴⁶

The Commission's goal should be to remove regulatory barriers to entry in the interstate jurisdiction -- not to shield non-LEC providers from competition. No purpose is served by creating "artificial" competition where alternative providers price under a highly regulated LEC "umbrella" in those areas where it is profitable to do so. Such an approach only creates vested interests in the status quo and deprives consumers of the true benefits of competition.

The fact that the participants to this proceeding cannot agree on the extent of competition should not dissuade the Commission from adopting a reasonable set of criteria for

⁴⁵See Attachment 1 hereto for U S WEST's response to some of the more extreme CAP proposals.

⁴⁶Professor Harris discusses the potential dangers of adopting such one-sided proposals in his review of the history of railroad regulation. He describes the damage to the nation's railroads that resulted from adopting regulatory proposals that favored the trucking industry. Harris Report at 7-9.

removing regulatory constraints on LEC services subject to competition. While this is not a simple task, it will not get any easier with increased competition. Now is the time to establish such standards.⁴⁷

U S WEST continues to believe that the USTA Proposal offers a reasonable means for identifying those LEC areas and services which are subject to effective competition. This proposal is based on the notion of addressability -- which essentially measures the extent to which customers have alternative sources of supply.⁴⁸ Addressability is an appropriate measure of market power.⁴⁹ In the absence of market power, there is no justification for rate regulation -- that is the reason CAPs are not subject to the same level of regulation as LECs. Likewise, LEC services should be removed from regulation where LECs lack market power.

As noted earlier, several parties suggest that the Commission need not adopt a transition mechanism in this proceeding -- but should defer consideration of such mechanisms

⁴⁷The Commission's experience in the Local Transport proceeding, CC Docket No. 91-213, indicates that the task of adopting reasonable criteria will become increasingly difficult as alternative providers respond to artificial pricing signals and move into market niches which they find to be highly profitable in today's environment of pervasive LEC regulation.

⁴⁸See USTA at Attachment 9, Competitive Market Area Demonstration and Data Reporting Requirements, at 11-12.

⁴⁹Market power is "the ability to restrict output or raise price over what would prevail in a competitive market, and maintain it over time." In the Matter of Competition, Rate Deregulation and the Commission's Policies Relating to the Provision of Cable Television Service, Report, 5 FCC Rcd. 4962, 4968 n.19 (1990).

indefinitely.⁵⁰ These parties would have the Commission ignore the very real and substantial changes that will certainly occur in interstate access markets during the life of the plan -- changes that are partly the result of the Commission's own policies.

U S WEST believes that competition already has emerged in interstate access markets in select geographic areas, and such competition will increase significantly in the very near future. If U S WEST is correct in its analysis, there would be substantial harm in deferring the adoption of a transition mechanism.

Conversely, no party will be harmed if the Commission adopts the transition mechanisms proposed by U S WEST and other LECs and no further competition emerges in interstate access markets. In this instance, U S WEST and other LECs presumably would fail to make a showing that the customers in a particular wire center have alternative sources of supply. Consequently, no transition mechanisms would be triggered and no LEC wire centers or services could be removed from price cap regulation or be the subject of streamlined regulation.

The failure to adopt a transition mechanism now will postpone the realization of the benefits of competition to consumers -- particularly lower prices.⁵¹ Delay will send distorted pric-

⁵⁰See AT&T at 19; Time Warner at 6; Sprint at 26; OCCO at 13.

⁵¹The Commission need look only to the recent interstate access tariff filed by MFS for evidence that consumers will be harmed by postponing the adoption of transition mechanisms for LECs. For example, that tariff includes a "Residual Interconnection Charge." As the Commission has noted, the residual interconnection charge is essentially a support flow. It is not
(continued...)

ing signals to new market entrants. These false signals may result in wasteful and inefficient investment in the network infrastructure by some providers.⁵² The Commission recognized the need to adopt a transition mechanism in its Notice of Proposed Rulemaking:

While the price cap plan gives LECs greater incentives to operate efficiently and greater flexibility in setting rates, it does impose significant regulatory constraints upon carriers. Such constraints may become unnecessary or counterproductive when market forces generated by competition effectively assure reasonable, and not unreasonably discriminatory rates. Rate regulation in these circumstances may impede the incumbent carrier's ability to compete vigorously rather than protecting customers or achieving the other goals of the Communications Act. In the case of AT&T, for example, price caps proved to be a transitional form of regulation for many services, which have since moved from price caps into streamlined regulation as competition increased.⁵³

Thus, the Commission should not delay in establishing criteria for determining when LEC services should be removed from price cap and other regulatory constraints. If no LEC services qualify -- which is highly doubtful -- no one will be harmed by the incorporation of such criteria in the LEC price cap plan. But the converse is not true. If the Commission fails to adopt

⁵¹(...continued)
clear how many MFS customers benefit from the inclusion of such a support flow in MFS' rates. MFS Intelenet, Inc., Tariff FCC No. 2, Access Services, issued Apr. 8, 1994.

⁵²USTA Reply at Attachment, Market Analysis and Pricing Flexibility for Interstate Access Services, by Richard Schmalensee and William Taylor, at 22; Harris Report at 4. See also GTE at Attachment A, Regulatory Reform for Local Exchange Carriers: Competition through Regulatory Symmetry, Statement of Dr. Mark Schankerman at 12.

⁵³Notice of Proposed Rulemaking, 9 FCC Rcd. at 1705 ¶ 92.

such criteria, the public interest, consumers, and LECs will be harmed in those areas and for those services subject to effective competition.⁵⁴

III. RATE OF RETURN PRESCRIPTIONS HAVE NO PLACE IN A PRICE CAP PLAN

Numerous parties argue that LEC PCIs should be reduced to reflect the decline in interest rates and the cost of capital since the inception of price cap regulation.⁵⁵ These parties ignore the basic tenets underlying price cap regulation in the pursuit of their own self interest. Adjusting LEC PCIs to reflect changes in the cost of capital, whether these changes be up or down, is totally at odds with the basic principles of price cap regulation.

Under price cap regulation, prices are capped by a set formula, and LECs are incented to provide service in the most efficient manner, regardless of what happens to the various cost components of the service. This is quite a change from rate of return regulation where regulators focused on costs -- and prices were literally a product of these costs. In its purest form,

⁵⁴Moreover, during the interim, the Commission's limited resources will continue to be diverted by an increasing number of waiver requests by LECs. See, e.g., Rochester's Petition for Approval of Proposed Restructuring Plan, Case No. 93-C-0103, filed Feb 3, 1993, and approved by the State of New York, Department of Public Service, on May 16, 1994, yet still not approved by the Commission. See also Ameritech's Petition for Declaratory Ruling and Related Waivers to Establish a New Regulatory Model for the Ameritech Region, DA 93-481, filed Mar. 1, 1993; GTE's Petition for Waiver, DA 93-977, filed Aug 3, 1993; NYNEX's Petition for Waiver, DA 93-1537, filed Dec. 15, 1993; Rochester's Petition for Waiver, DA 93-687, filed May 19, 1993.

⁵⁵AT&T at 30-33, Appendix D; MCI at 27, Appendix A; Ad Hoc at 25; CCTA at 5; OCCO at 7; GSA at 4, 6; WilTel at 25.

rate of return regulation removed virtually all incentives and uncertainty for regulated providers by allowing them to establish rates which covered all costs plus a "fair" rate of return on investment -- hence, the name "cost plus" regulation.

Clearly, rate of return regulation is not a very efficient way of regulating prices. Also, rate of return regulation does not make much sense if the goal is to protect consumers from "monopoly" pricing -- which has been one of the primary goals of virtually all common carrier regulation since its inception in the late 1800s. Under price cap regulation, provider costs, with few exceptions, have no impact on prices.⁵⁶ This is very similar to competitive markets where an individual firm's costs have no influence on the market price. Both in competitive markets and under price cap regulation, firms have the incentive to be as efficient as possible.⁵⁷ Firms are rewarded for increased efficiencies through higher profits and penalized for inefficiencies through lower profits or losses. A competitive firm will act quite differently if it is protected in some manner (e.g., a cost adjustment mechanism for a given type of costs) from the vagaries of the free market.

Incentives become distorted and input decisions are affected. This situation is even more aggravated in the case of price cap regulation if provider prices are adjusted for cost changes.

⁵⁶The only cost inputs in the LEC price cap mechanism are through the general inflation factor, the GNP-PI, and exogenous cost adjustments. As was mentioned above, U S WEST supports the elimination of exogenous cost adjustments.

⁵⁷Clearly, the sharing and low-end adjustment mechanism distorts LEC incentives somewhat under the current LEC price cap plan.

The net result starts to look very much like the circumstances which existed under rate of return regulation. Thus, rather than considering adjusting LEC PCIs for changes in capital costs or any other cost component, the Commission should be taking a step in the opposite direction by eliminating the sharing and low-end adjustment mechanism. This would eliminate the last vestige of rate of return regulation in the LEC price cap plan.⁵⁸

While the above discussion may seem like a tangential foray into Economics 101, it is not -- it is the heart of price cap regulation. The Commission cannot have it both ways -- it cannot obtain the benefits of price cap regulation and at the same time adjust prices for selected cost changes (e.g., as was the case under rate of return regulation).⁵⁹ Price cap regulation virtually guarantees that consumers of LEC access services will experience price changes that are at least 3.3 percent less than the general level of inflation. Conversely, LECs have no guaranteed return, only the opportunity to increase earnings through efficiency gains. This is a significant difference from rate of return regulation, particularly when the effects of compounding are taken into account.

⁵⁸Adopting any of the "cost of capital" arguments proposed in this proceeding will only encourage competitors to expend their energies in regulatory forums rather than in the marketplace.

⁵⁹The Commission recognized this when it determined that price cap regulation was a much more efficient form of regulation than rate of return regulation. In the Matter of Policy and Rules Concerning Rates for Dominant Carriers, Second Report and Order, 5 FCC Rcd. 6786, 6790 ¶ 29 (1990) ("Price Cap Order"); Order on Reconsideration, 6 FCC Rcd. 2637 (1991) ("Price Cap Order on Reconsideration").